Hastings International and Comparative Law Review

Volume 11
Number 3 *Spring 1988*

Article 2

1-1-1988

Tax Planning for Japanese Investment in the United States

Alan S. Woodberry

Neal W. Zimmerman

Tax Planning for Japanese Investment in the United States

By
ALAN S. WOODBERRY*
and NEAL W. ZIMMERMAN*

I. INTRODUCTION

Japanese investment in United States business is a common and fast growing phenomenon. Effective tax planning for such investment is vital for a Japanese multinational to maximize its after-tax return on its investment. This tax planning requires an understanding of a Japanese multinational's current and anticipated tax situation in both Japan and the United States. A general review of some of the more important Japanese and United States tax rules that affect cross-border investments appears in Appendix I. Flexibility is an essential component of tax planning because both countries frequently change their tax laws.

Tax planning is complex because of the many different tax laws, regulations, rulings, court decisions, and because of the variety of ways in which a company can structure and conduct its business. This paper covers certain structural tax issues that a Japanese company should consider when either acquiring or starting a business in the United States. Of course many non-tax factors, such as minimizing exposure to legal liabilities and foreign currency fluctuations, also affect a company's decisions.

The tax plan of one company will vary from that of another company owing to each company's unique situation, expectations, and non-tax considerations. Accordingly, each company must examine the alternatives available to determine its best course of action to minimize its overall tax burden over the long term.

* *Certified Public Accountant, International Tax Partner, Price Waterhouse, San Francisco; A.B. 1964, Dartmouth College; M.B.A 1965, Amos Tuck School.*

* *Certified Public Accountant, International Tax Partner, Price Waterhouse, Tokyo; B.A. and M.B.A. University of Washington 1963, 1964.*

II. SHOULD A JAPANESE CORPORATION OPERATE IN THE UNITED STATES THROUGH A UNITED STATES SUBSIDIARY OR A BRANCH?

A. United States Subsidiary Taxation

A United States subsidiary's income is subject to United States federal and state tax. Generally, net taxable income differs from net book income as a result of permanent differences, such as tax exempt municipal bond interest, and timing differences, such as use of accelerated methods of depreciation over shorter lives for tax purposes. The United States imposes a withholding tax on payments of income from a United States subsidiary to its Japanese parent. Interest and royalty payments are subject to a 10 percent United States withholding tax, provided that this income is not effectively connected with the Japanese parent's conduct of a United States business.[1] Dividend payments are subject to either a 10 or 15 percent United States withholding tax.[2] Payments for goods and services are generally exempt from United States withholding tax. All payments between affiliates must be determined on an "arm's-length" basis or they may be adjusted by the tax authority if it believes that insufficient taxable income is being reported.[3]

Japan does not tax income of the United States subsidiary until earnings are repatriated to Japan as a dividend. Furthermore, when the Japanese parent reports the dividend income in its Japanese tax return, the Japanese parent may claim a foreign tax credit against Japanese tax for the United States income taxes associated with the dividend.[4] Creditable United States taxes include the United States withholding tax imposed on the dividend and the underlying United States federal and state income taxes paid by the United States subsidiary.[5]

For underlying United States income taxes to be creditable in Japan, the Japanese parent company must own at least 10 percent of the United States subsidiary's voting stock directly[6] and only those underlying taxes paid with respect to dividends received for voting stock are creditable.[7] Further, only underlying United States and foreign income taxes paid by directly owned United States subsidiaries (so-called first-tier subsidiaries)

1. Convention on Double Taxation: Income, March 8, 1971, Japan-United States, art. XIII, art. XIV, 23 U.S.T. 967, 990-93, T.I.A.S. No. 7365 [hereinafter Japan-U.S. Tax Treaty].
2. *Id.* art. XII, para. 2, at 988.
3. I.R.C. § 482 (U.S. CODE CONG. & ADMIN. NEWS 1988).
4. Hojinzeiho (Corp. Tax Law), art. 69, para. 1.
5. *Id.* at art. 69, para. 4.
6. Japan-U.S. Tax Treaty, *supra* note 1, art. V, para. (1)(b), at 976.
7. Hojinzeiho Shikorei (Corp. Tax Law Enforcement Order), art. 147, para. 2, cl. 3.

are creditable.[8] No credit is allowed for United States income taxes paid by lower tier subsidiaries. In other words, if a United States subsidiary is the United States parent of a second-tier United States subsidiary, only United States and foreign income taxes paid by the United States parent can be claimed as foreign tax credits to offset Japanese tax of the Japanese parent when it receives a dividend.[9] In addition, if the first-tier company is a mere holding company, no indirect tax credit is available in Japan.[10]

Generally, in a United States consolidated tax return group,[11] the Japanese tax authorities accept reasonable allocations of the United States federal income tax under the group's tax sharing agreement in determining the United States parent's United States federal income tax liability. For Japanese tax purposes, the allocation of tax to the United States parent of the United States consolidated tax return group should not exceed the lesser of the tax the company would have paid if it had filed a separate return, or the tax actually paid by the group.[12]

In planning for dividends from its United States subsidiary, a Japanese parent should be aware of the effective United States federal, state, and city income tax rates paid on the United States earnings compared to the effective Japanese tax rate applicable to dividend income. The underlying United States income tax and withholding tax are usually insufficient to offset the Japanese tax on the dividend income, and frequently additional Japanese tax is due. For example, a Japanese parent based in Tokyo may have an effective tax rate on dividend income of 56 percent. This compares with an effective United States federal and state combined income tax rate before withholding of about 40 percent in California (ignoring permanent and timing differences).[13] Including the 10 percent United States withholding tax, the United States total effective tax rate

---

8. *Id.* at art. 146, cl. 3.

9. *Id.*

10. *Id.* at cl. 2.

11. An affiliated group eligible to file a consolidated tax return consists of a common parent corporation owning at least 80% of all classes of stock in at least one subsidiary corporation. (*See* I.R.C. § 1504(a) for stock ownership requirements.) All corporations in the group must be includible corporations (generally any domestic corporation). *See* I.R.C. § 1504(b).

12. Japanese tax law does not specifically address the question of how the allocation of United States federal income tax among members of a United States consolidated tax return group should be made. A system allowing for consolidated tax returns does not exist in Japan. Mr. Yoshio Watanabe, a tax official of the Japanese government, states that the tax to be allocated to the United States parent should not exceed the tax which it would have paid if it had filed a separate return. *See* Y. WATANABE, SHINPAN — GAIKOKU ZEIGAKU KOJO (Dobunkan Shuppan K.K. 1983).

13. The actual combined Federal and California tax rate is 40.138% calculated as follows:

increases to about 46 percent. The Japanese enterprise tax (13.2 percent rate) cannot be offset by foreign tax credits.[14] In such situations, the Japanese parent may prefer that the United States subsidiary defer paying dividends and reinvest its earnings in the United States to avoid paying both the United States withholding tax and additional Japanese tax.

The Japanese financial reporting system utilizes separate company financial statements, which are the primary financial statements in Japan. Generally, only these statements are mailed to shareholders.[15] Japanese publicly traded companies disclose consolidated financial statements as supplementary financial information in filings with the Ministry of Finance. These statements are available to investors.[16] The earnings of subsidiaries are recognized in the separate company financial statements of the parent only when dividends are distributed.

B. United States Branch Taxation

A Japanese corporation operating directly in the United States is currently subject to both United States and Japanese income taxes. Industrial or commercial profits attributable to a Japanese corporation's permanent establishment in the United States are subject to the 34 percent United States federal corporate income tax rate.[17] A permanent establishment includes a branch or office of the Japanese parent or the office of a United States, Japanese or other partnership engaged in a United States trade or business.[18]

In addition to the federal corporate income tax, the United States

Max. Federal Tax Rate	34.00%
Cal. Tax Rate	9.30%
Less Federal Benefit	(3.162%)
Effective Cal. Tax Rate	6.138%
Combined Total	40.138%

The "federal benefit" results from the reduction of federal taxes due to state tax liabilities. Since state taxes are deductible from federal taxable income, the effective state tax rate is lower than the stated rate. Permanent and timing differences refer to the different treatment of certain items for tax purposes under federal and California tax laws. Since state taxes are deductible in the computation of federal, but not California taxes, the different treatment is a permanent difference. If, however, an item was being depreciated over 5 years for federal purposes, and 7 years for California purposes, the difference would only vary in the timing of the item's deductibility.

14. There is no clause in the enterprise tax section of the Local Tax Law which allows the Japanese enterprise tax to be offset by foreign tax credits.

15. Shoho (Commercial Code), art. 33.

16. Ministry of Finance Ordinance no. 33 (1976).

17. I.R.C. § 11.

18. Japan-U.S. Tax Treaty, *supra* note 1, art. IX, at 984 lists business forms which constitute "permanent establishments."

initiated two new branch taxes beginning in 1987.[19] The new branch profits tax and branch interest tax treat a branch of a foreign corporation, whether operated directly or through a partnership, as if it were a United States corporation. The branch profits tax is essentially equivalent to a dividend withholding tax and is imposed on profits of a branch, except to the extent those profits are reinvested in the United States branch. The Internal Revenue Service (IRS) has ruled, however, that generally the Japan-United States Tax Treaty prevents application of the branch profits tax to a Japanese corporation.[20]

Recognizing that some tax treaties override the branch profits tax, the United States tax law has a second method of taxation. Under this alternative method, the United States imposes withholding tax on dividend distributions by a foreign corporation to its shareholders if at least 25 percent of the foreign corporation's gross income for the prior three years was derived from a United States business.[21] The Japan-United States Tax Treaty also provides an exception from this tax for dividends paid by a Japanese corporation to Japanese residents by treating such distributions as foreign source income.[22]

A portion of a Japanese corporation's interest expense is apportioned to the United States branch and is deductible in calculating United States taxable income under detailed rules.[23] When the United States branch's interest deduction exceeds the amount of interest paid by the branch, the branch interest tax can apply. It is unclear if the Japan-United States Tax Treaty prohibits imposition of the new branch interest tax, but should the branch interest tax apply, the Treaty reduces the tax rate to 10 percent.[24] The technical corrections provisions to the 1986 Tax Reform Act, which have not yet been enacted, presently provide that the branch interest tax does not override income tax treaties with the United States for qualified treaty residents.

A state generally taxes the portion of a corporation's net income apportioned to that state according to a three factor formula: sales, payroll, and property. Compared to conducting business through a United States subsidiary, application of the three factor apportionment formula may result in greater or less state tax, depending on the particular cir-

19. I.R.C. § 884.

20. I.R.S. Notice 87-56, 1987-2 C.B. 367.

21. I.R.C. § 861(a)(2)(B).

22. Japan-U.S. Tax Treaty, *supra* note 1, art. VI(1), at 977.

23. Treas. Reg. § 1.882-5 (as amended in 1973).

24. I.R.C. § 884(f)(1); Japan-U.S. Tax Treaty, *supra* note 1, arts. VII & XIII(4), at 981, 990.

cumstances. A few states determine tax liability according to a unitary formula which ignores legal entities in calculating the taxable income derived in a unitary business from a particular state. California is the best known state for applying the unitary formula. California allows multinationals to opt out of possible application of the unitary formula for a simple election fee.[25] Yet some foreign multinationals are fighting California's use of the unitary method.[26]

A Japanese corporation is subject to Japanese tax on its worldwide income.[27] The amount of Japanese taxable income or loss generated by a United States branch differs from the amount calculated for United States tax purposes because for Japanese tax purposes the computation is made under Japanese tax rules. Japan reduces its tax by giving credit for United States federal and state income taxes paid. The amount of foreign tax credit allowed, however, is subject to the Japanese foreign tax credit limitation.[28] To compute the Japanese foreign tax credit limit, an allocation of interest expense is required. Interest on debt specifically identified with a particular investment is allocated against the income from that investment. All other interest is basically allocated on an asset basis.[29]

Because United States tax rates are significantly lower than Japanese tax rates, the credit limit does not usually restrict the ability of a Japanese corporation to claim credit for United States federal and state taxes. Thus, it is important for a Japanese corporation considering operating in the United States through a branch to first analyze its ability to fully utilize United States federal and state taxes as foreign tax credits.

C. Comparing a United States Subsidiary to a United States Branch

United States taxation differs depending on whether the foreign corporation operates as a United States subsidiary or branch. In general, a United States branch does not offer any significant United States tax advantages over a United States subsidiary. In Japan, however, choice of form affects taxes. A United States subsidiary allows deferral of Japanese tax on United States income until a dividend is paid and precludes use of a United States loss to reduce Japanese tax.[30] Alternatively, the income

25. Cal. Rev. & Tax Code § 25115 (Deering 1988).

26. Barclays Bank International Ltd. v. Franchise Tax Board, Ca. Super. Ct. No. 325059, June 16, 1987.

27. Hojinzeiho (Corp. Tax Law), art. 4, para. 1 & art. 5.

28. *Id.* at art. 69, para. 1.

29. Hojinzeiho Shikorei (Corp. Tax Law Enforcement Order), art. 142, para. 6 and 16-8-11 of the Basic Administrative Instruction for Interpretation of Corporation Tax Law issued by the Chief of the National Tax Agency.

30. Hojinzeiho (Corp. Tax Law), art. 23.

or loss of a United States branch is calculated into the Japanese corporation's worldwide income or loss.[31] In addition, income earned by a foreign branch of a Japanese company is not subject to the enterprise tax (13.2% rate).[32] On the other hand, dividends from a United States subsidiary are subject to the enterprise tax and no foreign tax credit is allowed against the enterprise tax.[33]

In the authors' experience, most Japanese corporations conduct business in the United States through United States subsidiaries[34] thereby allowing deferral of Japanese tax until the earnings are distributed to the Japanese parent. However, there are two principal exceptions: (1) industries that operate through United States branches for non-tax business reasons, such as airlines, shipping companies, and banks in which the United States branches rely on the head office's capital, and (2) investments which are expected to generate tax losses, particularly highly leveraged real estate investments.[35] When United States loss activities turn profitable, the United States branch may be replaced by a United States subsidiary.

III. SHOULD ASSETS OR STOCK BE ACQUIRED IN A UNITED STATES BUSINESS?

Generally a buyer of a United States business prefers to purchase the assets of the business rather than the stock for two reasons. First, a purchase of assets generally does not involve assuming undisclosed product liabilities, taxes or other claims against the business that arose prior to the acquisition. Second, a purchase of assets allows the tax basis of

31. *Id.* at art. 4, para. 1 & art. 5.

32. Chihozeiho (Local Tax Law), arts. 72-15.

33. Although not directly addressed in Japanese tax laws, Chihozeiho (Local Tax Law), arts. 72-14, para. 1 indicates that taxable income for purposes of the national corporation tax should be used as the base for enterprise taxable income except for items specified in the Local Tax Law. The provisions of Local Tax Law, arts. 72-15, exclude certain items from the taxable base for enterprise tax purposes. Excluded items are those items of income and related expenses incurred in connection with a place of business located outside Japan (*i.e.*, a branch in a foreign country). Furthermore, in accordance with the provisions of article 3 of the administrative instruction for interpreting "foreign source income" for enterprise tax purposes, which was issued by the Chief of the Tax Bureau in the Ministry of Home Affairs on November 25, 1961, even if a domestic corporation has a permanent establishment in a country outside Japan, and even if the corporation earns foreign source income, the income is taxable for enterprise tax purposes if such foreign source income is not attributable to the permanent establishment. Consequently, dividend income earned by a Japanese corporation from its United States subsidiary is not excludable for enterprise tax purposes.

34. Conclusions are based on Price Waterhouse's experience with its Japanese clients.

35. *Id.*

tangible and intangible assets to be stepped up to the purchase price, which includes liabilities assumed.

On the other hand, the seller of a United States business generally prefers to sell the stock for two reasons. First, a stock sale relieves the seller of future problems arising from contingent liabilities of the business. Second, the seller can avoid double taxation which often results when the sales proceeds of an asset disposition are distributed to a shareholder, other than an 80 percent or greater corporate shareholder. When the parties do agree to a stock sale, the buyer often requires that the seller provide certain warranties and guarantees in the sales agreement to protect against contingent liabilities. Sometimes part of the purchase price is withheld for a period of time to partially offset undisclosed liabilities.

A. Asset Acquisition

The allocation of the purchase price among the assets acquired may significantly impact future tax deductions. For tax purposes, but not necessarily for financial statement purposes, a purchaser generally wants to allocate purchase price to assets that will generate tax deductions at the earliest time, such as inventory and depreciable or amortizable assets with short lives.

The allocation of purchase price in a major acquisition is generally made pursuant to an appraisal obtained from an independent appraisal firm or an accounting firm that has appraisers. While the IRS is not required to accept such an appraisal, a professional appraisal opinion prepared at the time of the acquisition may be difficult for the IRS to challenge.

Generally, part of the purchase price is allocated to intangible assets. For an intangible asset to be amortized for tax purposes, the acquirer must demonstrate both: (1) the value of the intangible, and (2) the useful life of the intangible.[36] If the acquirer can demonstrate a useful life, estimated with reasonable accuracy, the allocable cost can be amortized over that life. Since goodwill and going concern value do not have lives, they cannot be deducted for tax purposes unless the business that they are attributable to is disposed of or abandoned. Certain intangibles, such as patents, have fixed lives and can be amortized.[37]

Many other intangibles have less certain lives. These assets include customer and subscription lists, the existing core deposit of a bank, the insurance in force of an insurance company, and a workforce in place.

36. Treas. Reg. § 1.167(a)-3 (1960).
37. *Id.* at § 1.167(a)-6(a).

Advertising relationships and a customer or circulation base in the case of a broadcast, cable, newspaper, or similar business may also be included as intangibles with uncertain lives. United States acquirers and their appraisers often carefully value such assets and determine their useful lives based upon statistical information. The IRS, on the other hand, often takes the position that such assets are not depreciable because certain customers may be lost but others can be expected to replace them and, accordingly, such assets may be treated as goodwill or going concern value having no useful life.[38]

In some cases the courts have flatly refused to allow amortization of such intangibles.[39] In other cases where an intangible, such as a customer list, has been separately valued with a price put on each customer and a life determined in a statistically valid manner, courts have allowed amortization.[40] The IRS tried to terminate this controversy by proposing legislation for the 1987 Tax Act. This legislation declared that the cost of customer base, market share or any renewing or similar intangible has an indeterminate life and cannot be amortized. However, in enacting the 1987 Tax Act, the legislature dropped this provision. The controversy between the IRS and taxpayers continues.

Another important asset to consider in the allocation of the purchase price is a covenant not to compete. Any amount allocated to a covenant not to compete can be amortized over the useful life specified in the sale agreement.[41] The only reliable way for a buyer to receive a tax deduction for a covenant not to compete is to include it in the sales agreement.[42]

Special rules applicable to a transfer of a franchise, trademark or trade name provide a tax planning opportunity. To the extent payments are contingent on the productivity, use or disposition of the franchise, trademark or trade name transferred, the buyer receives an immediate tax deduction for the contingent payments.[43] To the extent the seller retains a significant right,[44] part of the purchase price can be allocated to a franchise, trademark or trade name and the allocated amount can be

38. *See* I.R.C. § 1060 & Treas.Reg. § 1.338(b)-2T (as amended in 1986). *See also* Nelson Weaver Realty Co. v. Commissioner of Internal Revenue, 307 F.2d 897 (5th Cir. 1962) for a general discussion of the IRS's treatment of goodwill and the covenant not to sue.

39. Winn-Dixie Montgomery, Inc. v. United States, 444 F.2d 677 (5th Cir. 1971).

40. Seaboard Finance Co., 33 T.C.M. (Prentice Hall) 64-1655 (1964).

41. Annabelle Candy Co. v. Commissioner of Internal Revenue, 10 A.F.T.R. 2d 5500 (9th Cir. 1962).

42. Better Beverages, Inc. v. United States 61 F.2d. 424, 430 (5th Cir. 1980).

43. I.R.C. § 1242(d).

44. As defined in *id.* at § 1242(b)(2).

amortized over a ten year or possible shorter period.[45]

The Tax Reform Act of 1986[46] provides that the purchase price is to be allocated in the following order: first, to cash and cash items; second, to marketable securities and other similar items in proportion to their fair market values; third, to all other tangible and intangible assets, except for goodwill and going concern value, in proportion to their fair market values; and fourth, to goodwill and going concern value.[47] Trade receivables would be in the third group. In the case of a bargain purchase, a buyer may allocate an amount to the receivables that is less than the face value of the receivables. When this occurs, the buyer has immediate income recognition upon collection of those receivables at face value.

Another new rule requires both the seller and the buyer to use the above method for allocating the sales/purchase price among the various assets.[48] Before 1987, sellers allocated as much sales price as possible to capital assets to benefit from the lower tax rate for capital gains. Furthermore, buyers would allocate as much purchase price as possible to assets that would result in quick tax deductions. Now that capital gains and ordinary income are subject to the same tax rate, sellers are less likely to be concerned about the allocation of purchase price. However, there still can be tax consequences to the seller as a result of a particular allocation, because, for example, capital losses cannot offset ordinary income. The buyer and seller should consider including the allocation of the purchase price in the sales agreement to minimize potential problems with the IRS.

Most book/tax timing differences disappear in an asset acquisition. One example of a difference that survives is deferred compensation which has been accrued as a liability, but cannot be deducted until paid. The buyer cannot deduct the payment when made because the services were provided to the seller. If such a liability is assumed by a buyer in an acquisition, no tax deduction is allowable to either the seller or buyer. Accordingly, it may be preferable to leave such a liability with the seller to pay later. Warranty reserves are also treated like deferred compensation liabilities. The buyer assumes the warranty reserves and no deduction is allowed when the buyer pays claims related to its warranty

45. *Id.* at § 1253 (d).

46. Pub.L. No. 514, § 701, 100 Stat. 2320 (1986). Tax Reform Act of 1986 § 2a0 redesignated the Internal Revenue Code of 1954 as the Internal Revenue Code of 1986.

47. Treas. Reg. § 1.338(b)-2T(b) (1986).

48. I.R.C. § 1060.

obligations.[49]

When assets are acquired, the tax attributes and accounting methods of the seller remain with the seller and do not carry over with the purchased assets. If the buyer does not already have established accounting methods, new ones must be adopted. Such accounting method choices include, among others, the year end, a method to calculate inventory costs First In, First Out (FIFO) or Last In, First Out (LIFO), and whether to capitalize or expense research and development costs. Most of these decisions must be made in the first tax return filed.

Finally, there are other sundry matters to consider in an asset acquisition. A buyer should be aware that most states impose sales tax when personal property is sold, though some states exempt bulk asset sales from this tax.[50] Most states or local governments impose real property tax, and in California, a revaluation of that property occurs when the property is transferred to an unrelated person.[51]

B. Stock Acquisition

In a stock purchase, the tax basis of the underlying assets in the target company and its accounting methods carry over.[52] The year end of the target company may change to conform with that of a United States parent in a United States consolidated tax return group.[53] The target company's tax attributes which have not been used, such as net operating losses and various tax credits, also carry over.[54]

The use of net operating loss carryovers is limited when there has been a greater than 50 percent change in ownership of the United States loss company during a three-year period.[55] The ownership change can occur either in taxable transfers of ownership or tax-free reorganizations.[56] After the ownership change, the losses can only be offset against future income of the loss company. The amount of loss that can be used is limited to the value of the loss company at the time of the ownership change multiplied by the federal long-term tax-exempt rate published by the IRS.[57] For example, if a loss corporation is worth $10,000,000 and

---

49. Priv. Ltr. Rul. 8,741,001 (June 16, 1987).

50. *See* PRENTICE HALL, ALL STATES TAX GUIDE para. 253, n.53 (1987) for examples of states exempting bulk sales transfers.

51. CAL. CONST. art. XIIIa, §§ 2, 51, 110.1.

52. I.R.C. § 381.

53. Treas. Reg. § 1.1502-76(a) (as amended in 1973).

54. I.R.C. § 381(c).

55. *Id.* at § 382.

56. *Id.* at § 382(g).

57. *Id.* at § 382(b)(1).

the rate is 7 percent, under new ownership the loss corporation could use $700,000 of its preownership change net operating losses annually to offset income.

The loss corporation is also restricted by the requirement that it continue its historic business or use a significant portion of the old assets in a business during the two-year period after the ownership change.[58] Otherwise, the net operating loss would be disallowed in total.

Future losses of a loss company can be used to offset income of any member of its consolidated tax return.[59] Preacquisition net operating losses can be carried over to offset income only of the company that generated the losses. This restriction does not apply if the acquiring company is the loss company.[60] This restriction may be effectively avoided by merging the loss company into a profitable company or transferring profitable business into the loss company. Similar restrictions apply to tax credit carryovers following an ownership change.

A loss company that acquires a target company with a built-in gain is also subject to a limitation.[61] The loss corporation is not allowed to use its losses to shelter tax on built-in gains of a target company that are recognized within five years of the acquisition. Built-in gains include any income item that was attributable to a preacquisition period.

C. Stock Acquisition With a Step-Up in Tax Basis of Assets

When 80 percent or more of a United States company is acquired in a taxable purchase, the acquiring company can elect to treat the target company as having sold its assets and immediately repurchased them.[62] The target company's current tax liability arising from its deemed sale of the assets at fair market value usually exceeds the future tax benefit to be derived from stepping up the tax basis of the assets. Generally, the target company reports its taxable income from a deemed sale of assets in its own separately filed final tax return and not as part of a selling or acquiring parent's consolidated tax return. This election was far more popular prior to 1987 when a target company's gain on the deemed sale generally was not taxable except for depreciation and investment tax credit recapture.

When a target company has a net operating loss that either would be lost or severely restricted under I.R.C. section 382, an I.R.C. section

58. *Id.* at § 382(c).
59. Treas. Reg. § 1.1502-11 (as amended in 1980).
60. *Id.* at § 1.1502-1(f) (as amended in 1973).
61. I.R.C. § 384.
62. *Id.* at § 338.

338(g), election should be considered. The gain on the deemed sale of the target's assets can be offset by the target's net operating loss. Thus, the net operating loss could be used to obtain a step-up in asset basis. Otherwise, if the stock of the target company is purchased and no section 338(g) election is made, the loss is carried over to the buyer, but its use is limited by section 382.

If the target company is a member of a United States consolidated tax return group, in a stock acquisition both the selling group and purchasing group can jointly elect to treat the sale as an asset sale.[63] In addition, an election under I.R.C. section 338(h)(10) could be made by an affiliated group not filing a consolidated return to the extent prescribed in regulations, though these regulations have not yet been issued.[64] In a section 338(h)(10) election, the deemed sale of the assets by the target is treated as a taxable sale in the selling group's consolidated tax return. The seller recognizes no gain or loss on the sale of the target company's stock. In other words, there is only one level of tax on the gain and the buyer acquires a target company whose assets have a stepped-up basis for tax purposes.

The section 338 (h)(10) election can be particularly attractive in situations where the seller has net operating losses to offset gain, because the buyer may be able to obtain a step-up in the tax basis recognized on the deemed asset sale without a significant tax cost to either party. The election also can be very tax effective when the basis of the target company's stock in the hands of the seller is not significantly higher than the tax basis of the assets in the hands of the target company. In this situation a buyer may obtain a step-up in the tax basis of assets without significant additional tax cost to the seller. An illustration of the potential benefit of this election appears in Appendix II.

IV. HOW SHOULD THE OWNERSHIP OF UNITED STATES SUBSIDIARIES BE STRUCTURED?

A. Consolidated Tax Return

A United States parent company can elect to file a consolidated tax return with members of its affiliated group.[65] Affiliated group members are United States corporations in which the United States parent owns, directly or indirectly through other United States subsidiaries, at least 80 percent of the voting power and 80 percent of the total value of the

63. *Id.* at § 338(h)(10).
64. *Id.* at § 338(h)(10)(B).
65. *Id.* at § 150; Treas. Reg. § 1.1502-75(a), (b) (as amended in 1973).

stock.[66] Japanese corporations cannot be included in United States consolidated tax returns.[67] Similarly, United States sister companies that are subsidiaries of a Japanese parent company cannot file a consolidated return together unless they have a common United States parent company (See Appendix III).

The potential United States tax advantages of filing a consolidated tax return include:

(1) The tax loss of one member can offset the taxable income of another member;[68]

(2) Income derived from sales to members of the consolidated return group is not taxed until the asset giving rise to the gain is disposed of outside the group;[69] and

(3) Dividends can be distributed from one member to another member tax free.[70]

State tax planning can often be implemented within a consolidated tax return group without any adverse United States or Japanese tax consequences.

Nearly all United States owned corporate structures that are eligible to file consolidated tax returns do so in part to benefit from the tax advantages listed above. One United States tax disadvantage of filing a consolidated tax return, however, is that gain recognized from the sale of a subsidiary is subject to United States tax.[71] When a corporation is held directly by a foreign shareholder, gain from the sale is generally not subject to United States tax provided that the United States company is not a United States real property holding company.[72] A United States company is a United States real property holding company if at any time in the five-year period immediately preceding the sale more than 50 percent

66. I.R.C. § 1504.

67. *Id.* at § 1504(b).

68. Treas. Reg. §§ 1.1502-11 (as amended in 1980), 1.1502-21 (as amended in 1980).

69. *Id.* at § 1.1502-13(a)(1)(i) (as amended in 1973).

70. *Id.* at § 1.1502-14 (as amended in 1973).

71. The gain on the sale of a United States subsidiary by a United States shareholder is treated as United States source income under I.R.C. § 865(a)(1) and, absent losses to offset such gain, would create a tax liability.

72. I.R.C. § 897 taxes gain on the sale of United States real property holding companies. A United States real property holding company is defined in I.R.C. § 897 as a corporation in which the fair market value of its United States real property interests equals or exceeds 50% of the fair market value of its real property interests plus trade or business assets. Other capital gains from the sale of United States corporations by foreign shareholders, not derived from the sale of United States real property interests, are nontaxable foreign source capital gains (I.R.C. § 865(a)(2)). Such foreign source capital gains are not considered to be effectively connected (I.R.C. § 864(c)(4)) with a United States trade or business under I.R.C. § 882.

of the United States company's assets consisted of United States real estate, natural resources or both.[73]

Filing a consolidated return triggers several other potential technical United States tax considerations. Changing a United States company's structure may or may not be possible without taxation by the United States or Japan, depending on the desired change and the taxpayer's situation.

B. First-Tier Subsidiaries

As discussed earlier, a Japanese parent receiving a dividend from a United States subsidiary can claim a deemed-paid foreign tax credit for United States, state and foreign income taxes paid with respect to the earnings distributed as a dividend. For example, assume that a United States subsidiary has pre-tax earnings of 100 and federal and state income tax of 40 for a year. If the United States subsidiary pays a dividend of 30, the Japanese parent would receive 27 in cash after deducting the 10 percent United States withholding tax. The Japanese parent would report deemed paid foreign tax credit, that is the United States subsidiary's United States and state income tax attributable to the 30 of earnings paid in dividends to the Japanese parent. The Japanese parent could claim a foreign tax credit of 23, comprising 3 of direct withholding tax and 20 of deemed-paid foreign tax credit.

Under Japanese tax law only income taxes incurred by first-tier or directly owned United States subsidiaries are eligible to be claimed as foreign tax credits by the Japanese parent.[74] In other words, if there is a United States consolidated tax return group, only income taxes paid by the United States parent are potentially creditable against Japanese tax. Accordingly, many Japanese companies hold their United States and other foreign subsidiaries directly to allow maximum potential future deemed-paid foreign tax credit when earnings are repatriated to Japan.

When United States subsidiaries are directly held, the United States tax advantages of filing a United States consolidated tax return are not available. Accordingly, many Japanese companies are rethinking the structure for their United States subsidiaries, particularly when earnings of their United States subsidiaries are largely reinvested in the United States.

When a Japanese parent has a United States consolidated tax return group, the United States parent is often an operating company, because

73. I.R.C. § 897.
74. Hojinzeiho Shikorei (Corp. Tax Law Enforcement Order), art. 146, cl. 1.

mere holding companies are not allowed deemed-paid foreign tax credits with respect to dividends paid. The United States parent's business and assets should generate sufficient earnings to distribute normal dividends and pay adequate taxes to provide acceptable deemed-paid foreign tax credits with the dividend. Interest income, derived from loans by the United States parent to United States subsidiaries, can also help to increase the United States parent's earnings and United States tax burden while reducing the United States subsidiary's share of the United States taxes.

For Japanese parents with more than one United States subsidiary, combined Japanese and United States tax planning opportunities would be enhanced by changing Japanese tax law to allow deemed-paid foreign tax credit for income taxes paid by subsidiaries lower than the first-tier. Under United States tax law, deemed-paid foreign tax credits are allowable for foreign taxes paid by first-, second- and third-tier foreign subsidiaries.[75]

V. WHERE SHOULD FUNDS BE BORROWED TO FINANCE A UNITED STATES BUSINESS OR ACQUISTION?

The funds to start, expand or acquire a United States business of a Japanese parent could be borrowed in Japan, the United States, elsewhere or some combination of the three. Alternatively, the funds can be obtained by withdrawing them from existing investments.

If the Japanese parent borrows funds, the interest cost is deductible against Japanese taxable income, which is subject to the higher tax rate.[76] The borrowing by the Japanese parent could adversely affect foreign tax credit utilization because interest expense is allocated in Japan against foreign source income for purposes of computing the foreign tax credit limitation (See Appendix IV).[77] One economic issue to consider with this approach to financing is the Japanese parent's exchange risk in holding a United States dollar investment funded by what may be a yen obligation. Japanese companies have become very familiar with this issue with the strengthening of the yen during the last two years.

Borrowing by a United States operating company allows that com-

75. I.R.C. § 902.

76. Interest expenses are generally deductible as they accrue provided the deduction is not considered excessive in light of the circumstances. *See Business Operations in Japan*, Tax Mgmt. (BNA) Portfolio No. 51-7th, at A-33 (1984).

77. For a complete analysis of the Japanese foreign tax credit *see id.* at A-46-49.

pany to deduct the interest expense to reduce its taxable income (See Appendix V). This also reduces United States profits that could be repatriated to Japan which would be subject to United States withholding tax.

In purely United States structures, a United States holding company often borrows funds to acquire a new subsidiary. The parent company's interest expense can offset the subsidiary's income in a consolidated tax return. However, if a United States parent is owned by a Japanese parent, this may be undesirable because the United States parent's United States tax liability and potential to generate deemed-paid foreign tax credits would be diminished. Accordingly, a Japanese owned United States consolidated return group may do its borrowing through one or more subsidiaries in the United States consolidated tax return group.

If a United States company borrows funds from a lender located outside the United States, a 30 percent tax may be withheld on interest payments to the foreign lender.[78] Under the Japan-United States Tax Treaty, the United States withholding tax imposed on interest paid to a Japanese lender is reduced to 10 percent.

To minimize the interest cost on debt owed to foreign lenders, a United States borrower tries to avoid or minimize United States withholding tax. There is an exemption from United States withholding tax for portfolio interest paid on certain portfolio debt.[79] Portfolio debt can be in either registered or bearer form.[80] In general terms, to qualify a loan as a portfolio debt requires the following:

1. Certain procedural requirements must be fulfilled for either bearer or registered debt to insure that the debt instruments are held by non-United States persons and the interest is paid outside the United States;[81]

2. The interest cannot be received by an entity that owns directly, indirectly, or by attribution 10 percent or more of the borrower;[82] and

3. The lender cannot be a foreign bank.[83]

Accordingly, a Japanese lender that is not a bank and owns less than 10 percent of the borrower may be able to receive interest income from a United States debtor, free of United States withholding tax.

78. I.R.C. § 144.
79. *Id.* at §§ 871(h), 881(c).
80. *Id.* at § 881(c)(2).
81. *Id.* at § 163(f).
82. *Id.* at § 881(c)(3)(B).
83. *Id.* at § 881(c)(3)(A).

A. Avoiding Thin Capitalization

Thin capitalization exists when an owner of a subsidiary uses so much debt and so little equity to capitalize its subsidiary that the IRS can successfully assert that the debt should be treated as equity.[84] For example, if a Japanese parent capitalized its United States subsidiary with $1 million equity and $50 million of debt, the United States subsidiary would be thinly capitalized. The United States tax consequences to the Japanese parent of a United States subsidiary can be severe if it chooses to thinly capitalize its subsidiary. If the debt is treated as equity for United States tax purposes, no deduction is allowable for interest. Furthermore, both interest and principal payments are treated as dividends subject to United States withholding tax to the extent of the payor's current or cumulative earnings.[85]

Japanese tax law does not address the concept of thin capitalization. Therefore, Japanese companies may not be as familiar with the concept as United States taxpayers are. This is a potential trap that should be carefully avoided because of the adverse United States tax consequences.

In 1969 Congress directed the IRS to issue regulations with guidelines for determining when thin capitalization exists.[86] The IRS proposed and withdrew various regulations on the subject.[87] There are no official thin capitalization rules other than those outlined in many court cases which sometimes conflict.[88] Based on IRS attempts to promulgate regulations, a thin capitalization issue should be avoided if the following guidelines are satisfied:

1. The loan is documented by a note;
2. The loan bears an arm's length interest rate;

---

84. *See generally* John Kelley Co. v. Commissioner of Internal Revenue, 326 U.S. 521 (1946); Tyler v. Tomlinson, 414 F.2d 844, 848 (5th Cir. 1969); Charter Wire, Inc. v. United States, 62-2 U.S.T.C. para. 9, 845 (7th Cir. 1962).

85. Moughon v. Commissioner of Internal Revenue, 329 F.2d 399 (6th Cir. 1964).

86. The Tax Reform Act of 1986, Pub. L. Nos. 1-172, 83 Stat. 852 added I.R.C. § 385 to give the Commissioner authority to issue regulations providing rules for distinguishing debt from stock interests in all situations arising under the tax law. In response to this Congressional directive, the I.R.S. issued regulations in 1980 setting forth the factors that were to be taken into account in determining whether a debtor-creditor relationship or a corporation-share holder relationship existed in any particular factual situation. The regulations proved to be controversial and after postponing their effective date several times, the Treasury Department finally withdrew them in 1983.

87. *Id.*

88. RESEARCH INSTITUTE OF AMERICA, FEDERAL TAX COORDINATOR 2D, K-5100 Debt. v. Equity determines whether corporate obligations not subject to I.R.C. § 385 are debt or stock. *See* §§ K-5100-51 (1988) and the related footnotes, for a complete discussion of conflicting decisions on the topic of thin capitalization.

3. The inside (or related party) debt to equity ratio does not exceed 3 to 1;
4. The total (related and unrelated party) debt to equity ratio does not exceed 10 to 1; and
5. The debt is serviced when payments are due.[89]

Proper planning and documentation should allow a Japanese parent to avoid thin capitalization of its United States subsidiaries.

VI. HOW SHOULD JOINT VENTURES WITH UNITED STATES COMPANIES BE STRUCTURED?

In the United States, a joint venture may be structured as either a partnership or a corporation. The partnership form does not exist in Japan and is not always familiar to Japanese companies. United States companies often use partnerships. Partnerships do not pay taxes; they function as conduits.[90] This allows partnership losses or income to flow through to the partners. This permits each partner to do its own tax planning. Partnerships can also be used to specially allocate income or deductions among the partners.

The conduit nature of a partnership avoids another level of tax when a partnership is profitable. If a corporate joint venture is used instead of a partnership, the corporation pays regular federal and state taxes on its income.[91] A dividend distribution from the corporate joint venture to a United States corporate shareholder would also be taxable to the United States corporate shareholder, unless it owns 80 percent or more of the joint venture corporation.[92] If the United States corporate shareholder owns less than 20 percent of the corporate joint venture, 30 percent of the dividend is taxable.[93] If the ownership is between 20 and 80 percent, the taxable portion of the dividend is 20 percent.[94]

Partnerships can also have disadvantages. General partners are exposed to unlimited liability for obligations of the partnership.[95] A limited partner can have limited liability but cannot participate in the

89. *See* proposed and withdrawn Treas. Reg. § 1.385-1(e)(3) for guidelines regarding debt to equity rations. *See also* I.R.C. § 385.

90. I.R.C. § 701.

91. Treas. Reg. § 301.7701-2(a) (as amended in 1983) defines a corporation and I.R.C. § 11(b) provides corporate rates of tax.

92. I.R.C. § 243.

93. *Id.* at § 243(a)(1).

94. *Id.* at § 243(c).

95. Treas. Reg. § 301.7701-2(d)(as amended in 1983); *see* Rev. UNIF. LIMITED PARTNERSHIP ACT § 403 (1985).

management of the business.[96] This means that partners in an active business usually will be general partners.

Liability exposure may be restricted by having a separate United States subsidiary act as the general partner in the partnership. The liability exposure is limited to the assets of the United States subsidiary, in theory, although in many cases, other affiliates and the Japanese parent may remain liable because of the shipment of a product, the transfer of technology, or the need to protect their business reputation.[97]

From a tax standpoint, whether a Japanese corporation should enter into a corporate or partnership joint venture depends largely on whether the interest will be held directly by the Japanese parent or by a United States subsidiary.

If a Japanese parent owns a partnership interest directly, the Japanese parent's share of the partnership's income or loss is subject to the same United States and Japanese tax treatment as a United States branch, which was discussed earlier. Accordingly, the Japanese parent files United States federal and state income tax returns. This may not be desirable unless the partnership is expected to generate significant losses that can be used by the Japanese parent to reduce Japanese taxable income. Taxable income or loss for Japanese tax purposes needs to be computed under Japanese tax rules. One further complexity is that distributions from a United States partnership conducting business in the United States to a foreign partner are subject to United States withholding tax.[98] The withholding tax is not a final tax, but rather an estimated tax payment toward the Japanese parent's United States tax liability.

On the other hand, a Japanese parent's direct ownership in a United States corporate joint venture results in the same tax treatment as ownership of a United States subsidiary, assuming that the Japanese parent has a greater than 10 percent interest which enables it to claim deemed-paid foreign tax credit with respect to dividends.[99] For direct ownership by the Japanese parent of a profitable United States joint venture, use of a corporate joint venture is often preferable.

If a United States subsidiary holds the interest in the joint venture, generally, from a tax standpoint, a partnership structure is preferable to allow losses to flow through and avoid double taxation of income.

96. UNIF. LIMITED PARTNERSHIP ACT §§ 7, 17, 6 U.L.A. 559 (1969).

97. *See* International Shoe Co. v. Washington, 326 U.S. 310 (1945); Worldwide Volkswagen Corp. v. Woodson, 444 U.S. 286 (1980). *See also* Securities Investor Protection Corp. v. Vigman, 764 F.2d 1309 (9th Cir. 1985).

98. I.R.C. § 1446.

99. Japan-U.S. Tax Treaty *supra* note 1, art. V, para. (1), cl. (b), at 976.

Whether the United States subsidiary should be directly held by a Japanese parent or by a member of a United States consolidated tax return group raises the same issues discussed previously.

VII. CONCLUSION

Judge Learned Hand observed in 1934 that "[a]ny one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes."[100] For a Japanese company investing in the United States, one challenge is developing a tax plan that will minimize combined United States and Japanese taxes without unduly disrupting non-tax considerations.

100. Helvering v. Gregory, 69 F.2d 809, 810 (2d Cir. 1934).

APPENDIX I

COMPARISON OF MAJOR CORPORATE JAPANESE AND UNITED STATES TAX RULES

		JAPAN	UNITED STATES
1.	Type of System	Japan has a split rate system. The Japanese corporate tax rate is roughly 12% lower on earnings distributed to shareholders than on earnings retained in the corporation.	The U.S. has a classical double system.
2.	Corporate Tax Rates		

Japan	Regular Rate %	Reduced Rate %	United States	Rate %
Corporate income tax	42	32	Federal tax	34
Inhabitants tax (local tax) −20.7% (max. rate) of corporation tax due	8.69	6.62	State tax	0 to 10+
			Effective rates (resulting from deductibility of state taxes)	34 to 40+
Enterprise tax (local tax) max. rate	13.2	13.2	Some cities levy income taxes which are deductible in computing federal taxable income	
	63.89	51.82		
Effective rates (resulting from deductibility of enterprise tax for both corporate and enterprise tax purposes when paid)	56.44	44.37		

		JAPAN	UNITED STATES
3.	Corporate residence	A company incorporated under Japanese law is a Japanese resident.	A company incorporated under the laws of one of the states is a U.S. resident.
4.	Capital gains	Capital gains are taxable at regular tax rates. An additional surtax is imposed on certain real estate transactions.	Capital gains are taxable at regular tax rates.

		JAPAN	UNITED STATES
5.	Group relief	No group relief is permitted.	A group of U.S. corporations may file a consolidated tax return if there is 80% or greater common ownership under a U.S. parent company.
6.	Tax net operating losses	Net operating losses usually can be carried back 5 years and forward for up to 5 years.	Net operating losses usually can be carried back 3 years and forward up to 15 years.
7.	Exposure of foreign income to tax	A Japanese corporation is taxable on its worldwide income, including stock dividends, with worldwide losses available to offset worldwide income.	A U.S. corporation is taxable on its worldwide income with worldwide losses available to offset worldwide income.
8.	Income of foreign subsidiaries	A foreign subsidiary's income is subject to tax when the earnings are distributed as a dividend. Japanese shareholders of certain more than 50% Japanese owned foreign corporations, either incorporated or managed and controlled in designated low-tax-rate countries, are currently taxable on certain undistributed income of such foreign corporations.	A foreign subsidiary's income is subject to tax when the earnings are distributed as a dividend. U.S. shareholders of controlled foreign corporations are currently taxable on certain undistributed income (so-called Subpart F income).
9.	Thin capitalization (rule whereby if a subsidiary is capitalized with excessive debt (borrowed from its shareholder) relative to equity, some or all of the debt may be treated as equity for tax purposes).	Japan has no thin capitalization rules.	Generally the tests to avoid thin capitalization are as follows: (a) A loan should be documented by a note; (b) A note should bear an arm's length rate of interest; (c) The internal debt to equity ratio should not exceed 3 to 1; (d) The total internal and external debt to equity ratio should not exceed 10 to 1; and (e) The borrower should be expected to be able to service the debt.

	JAPAN	UNITED STATES
10. Relief from double taxation on foreign income	Avoidance of double taxation is achieved by allowing a foreign tax credit, including a deemed-paid foreign tax credit for underlying foreign company tax for 25% or greater direct corporate shareholders. Generally deemed-paid foreign tax credit is only allowable for foreign taxes incurred by a first-tier subsidiary. The 25% shareholder threshold can be reduced by a tax treaty, *e.g.*, the minimum ownership required under the Japan-U.S. Tax Treaty is 10%. Use of this credit is subject to a worldwide foreign tax credit limitation. Foreign taxes are deductible but not creditable in computing the enterprise tax.	Avoidance of double taxation is achieved by allowing a foreign tax credit, including a deemed paid foreign tax credit for underlying company tax for 10% or greater corporate shareholders. Deemed-paid foreign tax credit is allowable for foreign taxes incurred by first-, second-, and third-tier subsidiaries. Use of the credit is subject to complex foreign tax credit limitation provisions.
	Excess foreign tax credits can be carried back 5 years and forward 5 years.	Foreign tax credits can be carried back 2 years and forward 5 years.
	For corporation and inhabitants tax purposes, foreign income taxes may be claimed either as credits or deductions at the annual choice of the taxpayer.	Foreign income taxes may be claimed either as credits or deductions at the annual choice of the taxpayer.
11. Taxation of a foreign company with a local branch	Business income is subject to the same tax rates as corporate profits with no reduction in rates for dividend distributions. No Japanese tax is withheld on repatriation of branch profits.	Business income is subject to the regular federal and state tax rates. The amount of income subject to tax is determined under rules for sourcing income and apportioning deductions. Generally, the states apportion a corporation's net income. Unless reinvested in the U.S., business income is also subject to the U.S. branch profits tax. However, for most Japanese corporations, the Japan-U.S. Tax Treaty overrides the branch tax (IRS Notice 87-55 1987 - 2 C.B. 367). In certain situations, the U.S. may impose a second-tier witholding tax and the branch tax on interest.

	JAPAN	UNITED STATES
12. Taxation of income from subsidiaries paid to a recipient in the other country		
(a) Dividends Japan-U.S. Tax Treaty, *supra* note 1, art. XII, at 988.	15%*	15%*
(b) Interest Japan-U.S. Tax Treaty, *supra* note 1, art. XIII, at 990.	10%	10%
(c) Royalties Japan-U.S Tax Treaty, *supra* note 1, art. XIV, at 992.	10%	10%

* Reduced to 10% provided that the corporate recipient owned at least 10% of the corporate payor up to the time of payment and during the entire preceding taxable year and not more than 25% of the paying corporation's gross income consists of interest or dividends (unless received in the banking business or from certain related corporations). Japan-U.S. Tax Treaty, *supra* note 1, art. XII, at 988.

APPENDIX II

IRC SECTION 338(h)(10)

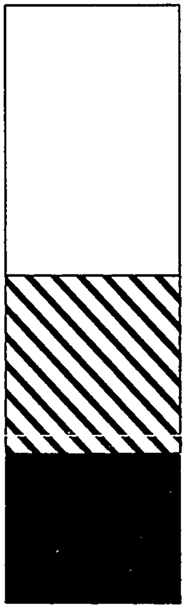
SALE OF STOCK

Sales Proceeds

Gain (Taxed at 34%)

Basis of Gross Assets

Basis of Stock



Gross Proceeds		100
Gain	$80	
x	34%	
Tax		27
Net Proceeds		73

Target's B/S

Assets	50	Liabilities	30
		Equity	20
	50		50

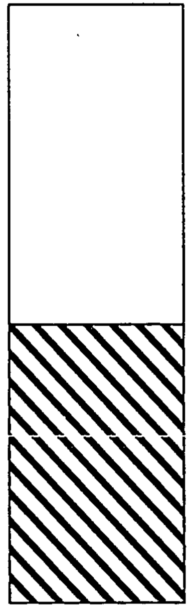
Note: Ignores State Taxes

SECTION 338(h)(10) Election

Sales Proceeds Plus Liabilities Assumed

Gain (Taxed at 34%)

Basis of Gross Assets



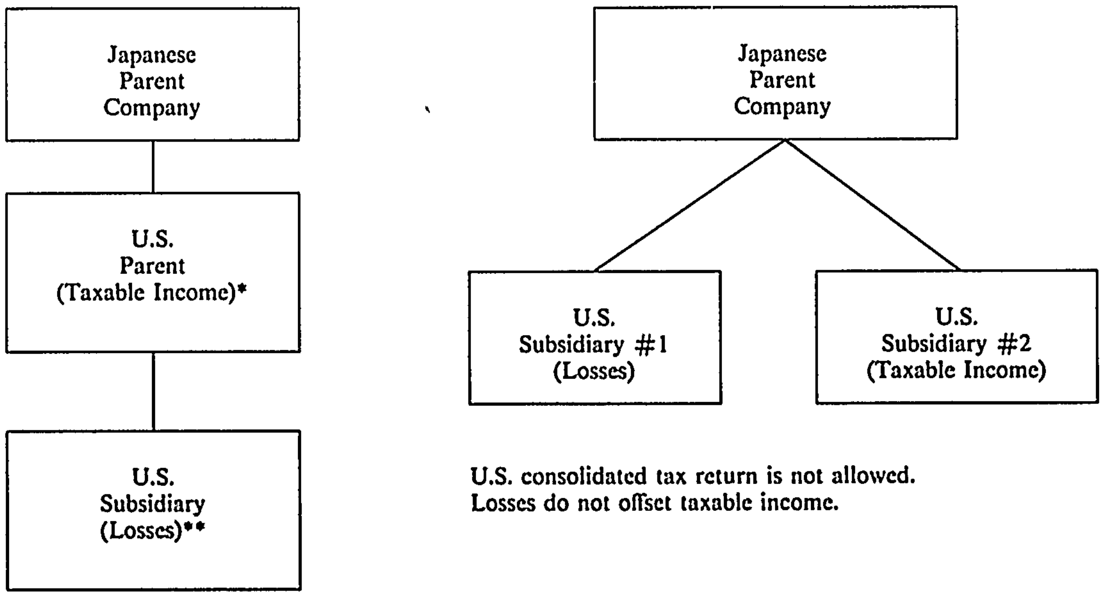
Gross Proceeds		100
Gain	$80	
x	34%	
Tax		27
Net Proceeds		73

Buyer	
Step up: ($130-$50)	$80
Tax Rate	34%
Net Benefit	27

Present value of step up: $17 (10 year period at 10% discount rate)

APPENDIX III

U.S. CONSOLIDATED TAX RETURN

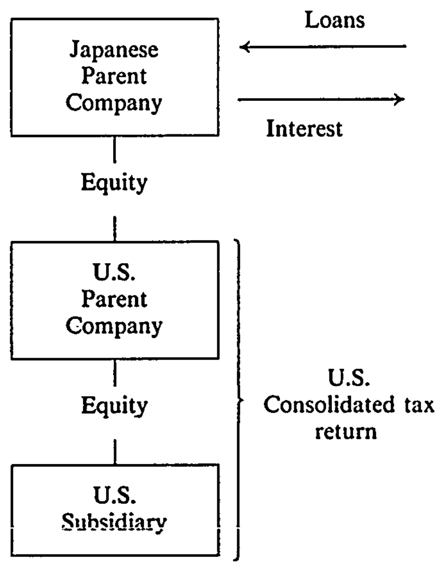


U.S. consolidated tax return is not allowed.
Losses do not offset taxable income.

U.S. consolidated tax return is allowed. Losses offset taxable income.
* U.S. parent can be a holding company for many subsidiaries.
** Subsidiary can also have subsidiaries down any number of tiers.

APPENDIX IV

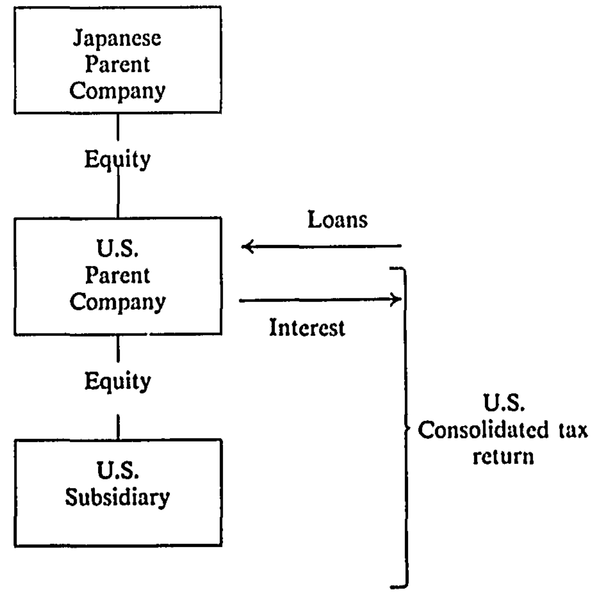
BORROW AND DEDUCT INTEREST IN JAPAN



a. Advantages:
   (1) Allows interest to be deducted against higher taxed Japanese sourced profits.
   (2) Establishes higher cost base for Japanese company's investment in the U.S. parent company.
b. Disadvantages:
   (1) Results in U.S. tax on profits before interest expense.
   (2) Interest expense reduces Japanese parent's foreign tax credit limitation.

APPENDIX V

BORROW AND DEDUCT INTEREST IN THE U.S.



a. Advantages:
   (1) Provides a natural hedge against exchange exposure.
   (2) Ensures that U.S. tax is paid only on net profit after taking into account interest expense.

b. Disadvantages:
   (1) Establishes a lower cost base for the Japanese company's investment in the U.S. parent company.